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Supreme Court, U.S.  
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**IN THE SUPREME COURT OF THE UNITED STATES**

**OCTOBER TERM, 1989**

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**WILLIAM F. OWEN and GRETCHEN K. OWEN,  
PETITIONERS**

**v.**

**COMMISSIONER OF INTERNAL REVENUE**

\_\_\_\_\_  
**PETITION FOR A WRIT OF CERTIORARI TO THE  
UNITED STATES COURT OF APPEALS  
FOR THE NINTH CIRCUIT**

\_\_\_\_\_  
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## QUESTION PRESENTED

Whether a taxpayer realizes a taxable *economic benefit* under 26 U.S.C § 357(c) (1982) at the time of a transfer of assets to his own corporation where the assets are subject to a continuing security interest for the taxpayer's recourse liabilities and the amount of the liabilities exceed the adjusted basis and fair market value of the assets transferred but the taxpayer is not released or discharged from economic responsibility for the liabilities either by the lender or the corporation.



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**PETITION FOR A WRIT OF CERTIORARI TO THE  
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COME NOW Petitioners William F. Owen and Gretchen K. Owen, through their attorney, and petition this Court for a Writ of Certiorari to review the judgment of the United States Court of Appeals for the Ninth Circuit.

## OPINIONS BELOW

The opinion of the United States Court of Appeals for the Ninth Circuit affirming the United States Tax Court decision in favor of the Commissioner of Internal Revenue appears in Appendix A to this Petition and is reported as *Owen v. Commissioner*, 881 F.2d 832 (9th Cir. 1989). The opinion of the United States Tax Court was consolidated for argument and disposition with *McEachron v. Commissioner*, appears in Appendix B and is reported as *Owen, et al v. Commissioner*, para. 87,375 PH Memo 1872 (1987).

## JURISDICTION

The judgment of the United States Court of Appeals for the Ninth Circuit was entered on August 9, 1989. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1) (1982).

## STATUTORY PROVISIONS INVOLVED

**Section 61** of Title 26 U.S.C. provides in relevant part:

Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items;

(12) Income from discharge of indebtedness;

**Section 118** of Title 26 U.S.C. provides in relevant part:

(a) In the case of a corporation, gross income does not include any contribution to the capital of the taxpayer.

**Section 351** of Title 26 U.S.C provides in relevant part:

(a) No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in

exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation.

(b) If subsection (a) would apply to an exchange but for the fact that there is received, in addition to the stock or securities permitted to be received under subsection (a), other property or money, then—

(1) gain (if any) to such recipient shall be recognized, but not in excess of—

(A) the amount of money received, plus

(B) the fair market value of such other property received;

**Section 357** of Title 26 U.S.C. provides in relevant part:

(a) Except as provided in subsections (b) and (c), if

(1) the taxpayer receives property which would be permitted to be received under section 351, 361, 371, or 374 without the recognition of gain if it were the sole consideration, and

(2) as part of the consideration, another party to the exchange assumes a liability of the taxpayer, or acquires from the taxpayer property subject to a liability,

then such assumption or acquisition shall not be treated as money or other property, and shall not prevent the exchange from being within the provisions of section 351, 361, 371, or 374, as the case may be.

(c) LIABILITIES IN EXCESS OF BASIS.—

(1) In the case of an exchange—

(A) to which section 351 applies,

if the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be.

**Section 358** of Title 26 U.S.C. provides in relevant part:

(a) In the case of an exchange to which section 351, 354, 355, 356, 361, 371(b), or 374 applies

(1) The basis of the property permitted to be received under such section without the recognition of gain or loss shall be the same as that of the property exchanged—

(A) decreased by—

(i) the fair market value of any other property (except money) received by the taxpayer,

(ii) the amount of any money received by the taxpayer,

(B) increased by—

(ii) the amount of gain to the taxpayer which was recognized on such exchange (not including any portion of such gain which was treated as a dividend).

**Section 362** of Title 26 U.S.C. provides in relevant part:

(a) If property was acquired on or after June 22, 1954, by a corporation—

(1) in connection with a transaction to which section 351 (relating to transfer of property to corporation controlled by transferor) applies,

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer.

**Section 1001** of Title 26 U.S.C. provides in relevant part:

(b) The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

**Section 1012** of Title 26 U.S.C. provides in relevant part:

The basis of property shall be the cost of such property, except as otherwise provided in this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses).

**Section 1031** of Title 26 U.S.C. provides in relevant part:

(1) No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.

**Section 1032** of Title 26 U.S.C. provides in relevant part:

(a) No gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation.

## STATEMENT OF THE CASE

This case originated by the Commissioner of Internal Revenue proposing income tax deficiencies for the years 1979, 1980 and 1981 against William F. and Gretchen K. Owen, Petitioners herein, and Stephen B. and Mary Jane McEachron. The Owens and McEachrons filed separate Petitions with the United States Tax Court challenging the deficiencies. By a Motion to Consolidate granted October 18, 1984, the cases were consolidated for purposes of trial, briefing and opinion. Prior to trial, concessions by the parties eliminated the controversies with respect to 1979.

The consolidated cases ultimately tried before the Tax Court involved two issues: (i) whether a gain must be recognized under 26 U.S.C. § 357(c) (1982) in 1981 because of a transfer of equipment to a controlled corporation, and (ii) entitlements to investment tax credits in 1980 and 1981. The Tax Court held for the Commissioner on both issues.

Because of their Minnesota residency, the McEachrons appealed the decision of the Tax Court against them to the United States Court of Appeals for the Eighth Circuit. In a summary opinion issued on November 30, 1988, the Eighth Circuit affirmed the decision of the Tax Court against the McEachrons. The case was reported as *McEachron v. Commissioner*, 873 F.2d 176 (8th Cir. 1988) and appears in Appendix C. The McEachrons chose not to appeal the decision.

Because of their California residency, the Owens appealed the decision of the Tax Court against them to the United States Court of Appeals for the Ninth Circuit. The case was argued and submitted to the Court below on December 5, 1988. In an opinion issued on August 9, 1989, the Ninth Circuit affirmed the decision of the Tax Court against the Owens. The Owens

seek review of the Ninth Circuit decision only as to the issue involving the Court's determination that they realized a taxable gain in 1981 under 26 U.S.C. § 357(c) (1982). They do not seek review of the Court's decision denying investment tax credit for 1980 and 1981.

In 1977, Messrs. Owen and McEachron organized McO Investment ("McO"), an equal general partnership engaged in real estate investment. In 1980, Owen and McEachron decided to enter the seismic drilling business and after several unsuccessful attempts to purchase an existing business, they started their own. On advice of counsel, they structured the new business by McO purchasing the necessary operations equipment and then leasing the assets to Western Exploration, Inc., ("Western") an equally owned corporation organized on January 1, 1980. They were advised this structure would permit the liability prone operations to be conducted under the protection of a corporation while allowing the tax benefits from depreciation and investment tax credits attributable to the ownership of the equipment to be realized by McO and passed through to Owen and McEachron for their personal deduction.

The seismic drilling business required McO's purchase of \$1,288,164 in operating equipment in 1980 and 1981, financed principally by bank loans. By May 26, 1981, the total McO consolidated bank loan was \$1,008,639 and was secured by purchase money security interests in the equipment. In addition, Owen and McEachron each personally guaranteed the entire McO bank loan and together pledged a personal \$100,000 certificate of deposit as additional loan collateral.

In 1981, the oil boom of the late 1970's began to falter and the financial picture with regard to the bank loan began to deteriorate. Western's cash flow from operations weakened, causing a default on its lease payments to McO, causing McO to default on its loan payments to the bank, and finally causing Owen and McEachron to honor personally their guarantees

of the bank loans. At the same time, the value of the equipment began to decline because of the economic outlook in the oil industry.

Owen and McEachron decided to sell their seismic drilling business to abate anticipated substantial future McO losses. In 1981, legal counsel advised them such a sale would be best facilitated by McO transferring the drilling business equipment and accompanying liabilities to Western so that Western's stock and or assets and liabilities could be sold as an integrated business.

On advice of counsel, Owen and McEachron met with the bank to discuss the possibility of the bank reducing its security interest in the McO equipment to be transferred to Western to avoid liabilities in excess of adjusted basis gain under 26 U.S.C § 357(c) (1982). Subsequently, on December 31, 1981, McO transferred all the equipment to Western.

Although counsel did not prepare any contemporaneous documentation regarding the transfer of equipment on December 31, 1981, Western did execute a Third Party Pledge Agreement with the bank on December 30, 1981, granting the bank a security interest in the equipment it had received from McO.

On December 31, 1981, the aggregate unpaid principal balance on the bank loan was \$988,008 and, as the Commissioner later determined, the adjusted basis of the equipment transferred by McO to Western was \$763,354. Thus, according to the Commissioner, liabilities to which the equipment was subject prior to the transfer exceeded McO's adjusted basis in the amount of \$224,654. McO had previously calculated the amount of its adjusted basis to be \$781,862, the amount counsel used in drafting its post-transfer documents.

The Commissioner began an audit of the McO-Western transaction in April 1982 and requested documentation from legal counsel regarding the December 31, 1981 equipment transfer to Western. In June or July 1982, counsel prepared two documents reflecting the earlier transaction which were both dated "as of" December 31, 1981. The first document, styled as a "Transfer Agreement," reflected that Western agreed to assume and pay only \$781,862 of the total \$988,008 in liabilities relative to the equipment it had received from McO, the amount of McO's calculated adjusted basis in the assets transferred to Western.

In the second document, an "Amendment" to the "Transfer Agreement," Western acknowledged that its equipment continued as security for the bank liabilities in excess of the \$781,862 it had expressly agreed not to assume in the December 31, 1981 transfer and that the excess amount of liabilities above this amount (\$224,654) was the sole obligation of McO.

On September 3, 1982, the bank released part of its security interest in the Western equipment granted under the Third Party Pledge Agreement. The total amount of the Western debt was then structured to provide that Owen and McEachron individually assumed personal liability for a portion of the indebtedness. In addition, McEachron reached an agreement to sell his 50% stock interest in Western provided Western's bank loan was further reduced by McEachron's personal assumption to reflect the then approximately then \$750,000 fair market value of the equipment.

The Commissioner determined that McO realized and must recognize a \$224,654 gain under 26 U.S.C § 357(c) (1982) in 1981 when McO transferred its equipment with an aggregate adjusted basis of \$763,354 to Western subject to liabilities of \$988,008.

Petitioners retained new counsel to represent them in the litigation of the tax controversy. The United States Tax Court

affirmed the Commissioner's determination and held that (i) the equipment was security for the full amount of the bank loan at the time of the transfer, (ii) Owen and McEachron did not have an agreement with the bank to release a security interest in any of the equipment transferred to Western at the time of the transfer, and (iii) Owen and McEachron's personal assumption of a portion of Western's liabilities in September 1982 was irrelevant at the time of the equipment transfer on December 31, 1981.

The Tax Court did not adopt the Commissioner's view regarding the effect of the \$100,000 certificate of deposit owned by Owen and McEachron and pledged as security for the equipment loan. The Commissioner argued that the certificate was not actually or effectively transferred to Western and should be ignored. The Tax Court held, however, that because the bank treated this amount as a reduction of the total loan amount on its books, this amount of the debt obligation was not transferred to Western and hence was not part of the liabilities in excess of basis. This finding reduced McO's 26 U.S.C. § 357(c) (1982) gain to \$124,654. In the years after 1981, because of the declining value of the equipment in Western's hands, Owen and McEachron personally paid most of the bank loan after the bank sold the equipment to pay part of its loan.

In the United States Court of Appeals for the Ninth Circuit, Owen argued that because he received no economic benefit from the transfer, he could not have had a "gain" because he was not in fact "better off." The Ninth Circuit rejected Owen's contention and affirmed the Tax Court's holding:

We decline the Owens' invitation because section 357(c)'s plain language makes no special provision for transfers not resulting in an economic benefit to the transferor. *Cf. Commissioner v. Asphalt Products Co.*, 482 U.S. 117, 120-121 (1987)(*per curiam*)(courts must give effect to the plain

language of the internal revenue code); *Commissioner v. Tufts*, 461 U.S. 300 (1983)(taxpayer may realize a taxable gain under I.R.C. § 1001 even without receiving a net economic benefit from the transferee).

The Ninth Circuit held that the decision expressed in *Commissioner v. Tufts*, 461 U.S. 300 (1983) clarified the scope of *Crane v. Commissioner*, 331 U.S. 1 (1947) by rejecting *Crane's* "limited theory of economic benefit" and thus seriously undercut the Ninth Circuit's earlier position expressed in *Jackson v. Commissioner*, 708 F.2d 1402 (9th Cir. 1983) that the tax system requires, as a prerequisite to taxation, that a transferor in a 26 U.S.C. § 351 (1982) transaction receive "economically significant consideration."

The Commissioner did not appeal the issue of whether the Owen and McEachron \$100,000 certificate of deposit pledged on the bank's equipment loan reduced the liabilities transferred to Western. Accordingly, it was not an issue before the Ninth Circuit. *Owen v. Commissioner*, 881 F.2d 832,835 at note 3 (9th Cir. 1989).

The Petitioners retained new *pro bono* counsel to prepare this Petition for a Writ of Certiorari. Although the contrary decision of the Second Circuit in *Lessinger v. Commissioner*, 872 F.2d 519 (2d Cir. 1989) provides the basis of this appeal, the economics of the case does not support paid representation.

## **REASONS FOR GRANTING THE PETITION**

This case involves a fundamental and pervasive question inherent in the income tax system: the effect of debt in property transactions. The context of the issue is a transfer of assets and liabilities to a controlled corporation in return for stock. Such transfers often involve, as is the case with Petitioners, transfers of the assets and liabilities of a pre-existing business operated as a sole proprietorship or a partnership.

Where the amount of the liabilities assumed by the corporation plus the amount of liabilities to which the transferred property is subject exceed the adjusted basis of the assets transferred, 26 U.S.C. § 357(c) (1982) requires the amount of the excess be treated as a "gain" from the sale of the assets transferred to the corporation. If, as a condition of the transfer, the shareholder also transfers a personal note to the corporation in the amount of the excess or remains personally liable on that amount of recourse liabilities transferred to the corporation, the statute does not state whether the transfer has economically benefited the shareholder so as to require immediate "gain" recognition under 26 U.S.C. § 357(c) (1982). Where the shareholder does not retain personal liability, the statute unquestionably taxes the immediate economic benefit resulting on the transfer of encumbered assets. But where the shareholder remains personally liable, is it not more appropriate to tax the 26 U.S.C. § 357(c) (1982) "gain" only when an identifiable economic benefit to the shareholder exists: that is, when the corporation either cancels the shareholder note or when the corporation pays the personal liability of the shareholder?

The Second Circuit has indicated, in a case involving a shareholder note, that the "gain" should be taxed only if the shareholder fails to pay the corporate note as would occur if the corporation cancels the note or the shareholder fails to treat it as true debt. Until those events occur, the Court found no economic benefit and therefore no income under 26 U.S.C. § 357(c). *Lessinger v. Commissioner*, 872 F.2d 519 (2d Cir. 1989).

After *Lessinger*, the Ninth Circuit held in this case that the shareholder's realization of an economic benefit at the time of the transfer was not a necessary condition of taxation under 26 U.S.C. § 357(c) (1982). *Owen v. Commissioner*, 881 F.2d 832 (9th Cir. 1989).

Many business incorporation transfers involve transfers of assets subject to liabilities that not only exceed the adjusted

basis of the assets but also exceed the value of the assets. In these instances, a newly formed corporation will have a negative net worth: its liabilities exceed the value of its assets and therefore its capacity to pay its creditors.

This post-transfer condition may often force shareholders to reassure creditors affected by the asset transfers that they will in fact be paid by the shareholder. Unsecured creditors may be willing to look to the corporation for future payment provided the shareholder can provide the corporation with financial stability. One method of accomplishing this result is for the shareholder to transfer his own note to the corporation in the amount by which the liabilities exceed the value of the assets. This personal liability of the shareholder would assure the lender that the corporation will have sufficient funds to pay its liabilities in the normal course of business.

This was the fact pattern present in *Lessinger v. Commissioner*, 872 F.2d 519 (2d Cir. 1989). Mr. Lessinger transferred his own note to his corporation in the amount of \$255,500, the amount the liabilities exceeded the basis and the value of the assets. The corporation paid the liabilities and Mr. Lessinger made payments on his note. *Ibid* at 521. The Commissioner argued that the note should be disregarded and Mr. Lessinger therefore found taxable at the time of the transfer on the amount of liabilities in excess of the basis of assets under 26 U.S.C. § 357(c) (1982). The Second Circuit held that Mr. Lessinger was not taxable because the note he transferred to his corporation negated any economic benefit he otherwise might have received from the transfer. *Ibid* at 526.

Secured creditors are concerned with the value of the assets serving as collateral for their loans. When the asset's value declines below the amount of the debt, the lender looks to the borrower personally to repay the loan in the case of a recourse liability. If the asset is transferred to a newly formed corporation, there is a corporate negative net worth (as

in *Lessinger*). Before acceding to the transfer, the lender looks to the original borrower for assurances the loan will be repaid because the corporation cannot be relied upon to repay a liability in excess of the value of the assets transferred to it. Then, if the assets are sold for less than the amount of the loan, the shareholders must personally repay the loan.

Such was the case for Petitioners. In the case below, Petitioners argued they should not be taxed under 26 U.S.C. § 357(c) (1982) because they received no economic benefit from the incorporation transfers. The Ninth Circuit rejected Petitioners argument on the grounds that 26 U.S.C. § 357(c) (1982) imposed a tax without regard to the existence of economic benefit. *Owen v. Commissioner*, 881 F.2d 832,835 (9th Cir. 1989).

One issue in this case is whether 26 U.S.C. § 357(c) (1982), or any provision of the tax code, should be interpreted to permit the inclusion of amounts in income where the taxpayer had no economic benefit. Another is whether there is a meaningful economic difference between the Petitioners' position after the incorporation transfers and that of Mr. Lessinger. Petitioners contend that there is not, and that the Second Circuit correctly decided the issue of the relationship of the economic benefit doctrine and 26 U.S.C. § 357(c) (1982).

Ordinarily, transfers of business assets and liabilities to a controlled corporation will not result in gain recognition to either the shareholder or the corporation. 26 U.S.C. §§ 351(a) and 1032 (1982). The receipt of stock in a controlled corporation is treated as a continuing investment in the transferred assets and therefore an inappropriate moment to tax the shareholder's unrealized appreciation in the transferred assets.

The gain is deferred or postponed, not eliminated. Gain deferral is achieved through a substituted basis. The

shareholder's basis in the assets transferred to the corporation becomes the shareholder's stock basis. 26 U.S.C. § 358(a) (1982). When the stock is sold, the gain will be recognized. The corporation's basis in the transferred assets carries over from the shareholder. 26 U.S.C. § 362(a) (1982). The corporation will also recognize the shareholder's precontribution gain when it disposes of the assets. These basis rules result in a double taxation of the shareholder's unrealized precontribution gain.

Notwithstanding this general scheme, nonrecognition treatment will be denied when the shareholder significantly alters the form of the investment in assets. This would occur, for example, where the shareholder cashes out of the investment by exchanging the assets not merely for stock in a controlled corporation but in addition receives money or other property. Under this exception, a shareholder is required to recognize gain only where the receipt of the corporate stock is accompanied by the receipt of "other property" including money and the fair market value of any other property other than stock or securities of the transferee corporation. 26 U.S.C. § 351(b) (1982).

The corporation's "assumption" of a shareholder's liability in connection with an incorporation transfer or the corporation's acquisition of property from the shareholder "subject to" a liability is generally not treated as equivalent to a taxable receipt of money. 26 U.S.C. §§ 357(a) and 351(b) (1982). But if the liabilities exceed the adjusted basis of assets transferred in the same transaction, the shareholder is required to recognize "gain" in the amount of the excess of liabilities over basis, treated as gain from the sale or exchange of the transferred assets. 26 U.S.C. § 357(c) (1982).

The resolution of this case must consider the tax effect of a shareholder's retaining primary responsibility to pay recourse liabilities not assumed by the corporation but to which the transferred assets are subject in the form of a continuing security

interest. The continuing shareholder liability responsibility may be evidenced by a shareholder note to the corporation, as in the case of *Lessinger v. Commissioner*, 872 F.2d 519 (2d Cir. 1989), or, as in this case, the shareholder's failure to obtain a release from the liability coupled with facts demonstrating the lender continued to look to the shareholder for repayment notwithstanding the asset transfer to the corporation. In either event, the issue is the same: if the economic reality is that the shareholder will continue to pay the amount of liabilities in excess of basis, is immediate "gain" recognition on the transfers of property to a corporation in a 26 U.S.C. § 351 (1982) transaction appropriate? On this matter, the Second Circuit and the Ninth Circuit have collided on the presence and necessity of a shareholder economic benefit at the time of the transfer of assets to the corporation.

As reflected by the summary in Appendix D, the difference between the approach of the Second Circuit in *Lessinger* and the Ninth Circuit in *Owen* can be viewed as a difference of timing and character: when and how is it appropriate to tax Petitioners? The *Owen* approach under 26 U.S.C. § 357(c) (1982) produces an immediate gain characterized as a sale or exchange of the transferred assets. The *Lessinger* approach, however, produces a tax in the future (if the shareholder fails to pay the excess liability) on income characterized as ordinary income from the discharge of indebtedness under 26 U.S.C. § 61(a)(12) (1982).

The Ninth Circuit below in *Owen* would interpret 26 U.S.C. § 357(c) (1982) to presume the presence of a taxable economic benefit; tax Petitioners immediately on the presumed "gain" at the time of the transfer to the corporation equal to the amount of excess liabilities. Thereafter, if the shareholder actually paid the excess liabilities, the shareholder's basis in the corporate stock would be increased, resulting in an increased loss or reduced gain on the shareholder's future disposition of the stock.

The Second Circuit in *Lessinger* would not interpret 26 U.S.C. § 357(c) (1982) to presume the presence of an economic benefit merely from a transfer of property nominally subject to liabilities in excess of basis. Rather, the Court examined the facts surrounding the transfer of assets and liabilities to the controlled corporation as well as the purpose of 26 U.S.C. § 357(c) (1982) and concluded that a shareholder is not taxable on a hypothetical "gain" at the time of the transfer. Instead the Second Circuit interpreted 26 U.S.C. § 357(c) (1982) to impose tax on the nominally excess liability only if the shareholder no longer had continuing responsibility for payment. Under this approach, the 26 U.S.C. § 357(c) (1982) "gain" would be taxed only when the taxpayer is actually relieved of the excess liability by the corporation's payment. Mr. Lessinger will be taxed on discharge of indebtedness income in the future if the corporation forgave payment of his note or, by its action, absolved him from liability. The shareholder would not have an increase in the basis of his stock as a result of his continuing liability or a subsequent release from liability. If Mr. Lessinger pays the note to his corporation, as the Second Circuit expected, he could not have realized a taxable economic benefit either at the time of the transfer or anytime subsequent. The Court concluded that under these circumstances, Mr. Lessinger should certainly not be taxed on mythical "gain" at the time of the transfer merely on the basis of the raw statutory wording of 26 U.S.C. § 357(c) (1982). The Second Circuit reasoned that Congress could not have intended such a result. *Ibid* at 526-527.

### **I. Conflict Between Courts of Appeal**

The Ninth Circuit decision in the case below squarely conflicts with the Second Circuit's decision in *Lessinger* as to the requirement of the presence of an economic benefit under 26 U.S.C. § 357(c) (1982). The Ninth Circuit opinion in the case below does not cite the Second Circuit's *Lessinger* decision. The Courts' interpretation of 26 U.S.C. § 357(c) (1982) are precisely opposite. It may be that the Ninth Circuit was unaware

of the *Lessinger* decision. *Lessinger* was argued before the Second Circuit on December 8, 1988 and *Owen* was argued before the Ninth Circuit on December 5, 1988, four days earlier than *Lessinger*. The appellate brief in *Owen* was filed with the Ninth Circuit on April 4, 1988, nearly a year before *Lessinger* was decided on March 29, 1989 and after *Owen* was briefed and argued. *Owen* was decided on August 9, 1989.

The Second Circuit's *Lessinger* decision and the Ninth Circuit's decision in *Owen* are in direct conflict, without explanation, with respect to the application of the economic benefit doctrine in 26 U.S.C. § 357(c) (1982) transactions. This unexplored conflict will make it difficult for the the lower courts to resolve disputes turning on the interpretation of 26 U.S.C. § 357(c) (1982).

In the United States Tax Court, taxpayers residing in the Second Circuit would benefit from *Lessinger* under the Tax Court's rule expressed in *Golsen v. Commissioner*, 54 T.C. 742,757 (1970), *aff'd*. 445 F.2d 985 (10th Cir. 1971), *cert. denied* 404 U.S. 940 (1971). Under this rule, the Tax Court would be required to follow the Second Circuit's *Lessinger* position in cases appealable to the Second Circuit. In cases appealable to the Ninth Circuit, the Tax Court may be expected to follow *Owen*. In other cases, the Tax Court remains free to adopt either Circuit's view or some alternative of its own, although thus far its view has been consistent with the Commissioner's and the Ninth Circuit's.

*Lessinger* conflicts not only with the Ninth Circuit *Owen* decision, but also with the Eighth Circuit's position in *McEachron v. Commissioner*, 873 F.2d 176 (8th Cir. 1988). The brevity of that Court's affirmance of the Tax Court's consolidated case with *Owen* makes it difficult to understand whether it also rejected the Second Circuit's interpretation of 26 U.S.C. § 357(c) (1982) as requiring an economic benefit for there to be a taxable "gain." Presumably, the Eighth Circuit would follow the Ninth

Circuit rationale; it reached the same result as the Ninth Circuit in *Owen* and it was briefed and argued by the same counsel as *Owen*.

Finally, the conflict may be broader than the Second Circuit versus the Ninth and Eighth Circuits. It may include the Third Circuit, which in 1975 affirmed without an opinion a Tax court decision consistent with the Ninth Circuit's later decision in *Owen*. *Rosen v. Commissioner*, 62 T.C. 11 (1974), *aff'd without published opinion*, 515 F.2d 507 (3d Cir. 1975). Because the Ninth Circuit's *Owen* decision does not analyze the Second Circuit's *Lessinger* decision, uncertainty continues in all tax forums because of the possibility that the result in *Owen* might have been different if *Lessinger* had been considered.

Certiorari should be granted to provide clarity and certainty in this important field of business transactions. This Court's resolution of the scope of 26 U.S.C. § 357(c) (1982) will avoid certain and continued future litigation in the Tax Court and the Circuit Courts.

## **II. Conflict With This Court's Economic Benefit Analysis**

Income is broadly defined under the current tax system to include income "from whatever source derived." The term "income" clearly includes income from discharge of indebtedness under 26 U.S.C. § 61 (a)(12) (1982). This definition is thought to include any economic benefit accruing to the taxpayer during the taxable year. *Glenshaw Glass, Co. v. Commissioner*, 348 U.S. 426 (1955).

The income tax analysis of transactions in which the taxpayer has economically benefited from discharge of debt is divided into two broad areas: recourse and nonrecourse liabilities. Income or gain accruing from transactions involving debt tends to be disguised. The benefit realized by the taxpayer is ordinarily

not realized in a direct payment of cash; rather it is connected to a liability reduction or release through a third party payment on the debt on behalf of the taxpayer or transferring property subject to a debt. As stated in *Helvering v. Bruun*, 309 U.S. 461, 469 (1940): "While it is true that economic gain is not always taxable as income, it is settled that the realization of gain need not be in cash derived from the sale of an asset. Gain may occur as a result of exchange of property, payment of the taxpayer's indebtedness, relief from a liability, or other profit realized from the completion of a transaction."

Accordingly, a taxpayer will realize income if an employer pays an employee's legal liability: "The discharge by a third person of an obligation to him is equivalent to receipt by the person taxed." *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716, 729 (1929). Similarly, a taxpayer realizes an economic benefit when relieved of the gift tax liability accruing from a gift in which the donee, as a condition of the gift, assumes and pays the donor's statutory gift tax liability. *Diedrich v. Commissioner*, 457 U.S. 195, 197 (1982).

These situations all involve a third party payment of the taxpayer's legal obligation. It is payment and the concomitant economic benefit received by the taxpayer that is the subject of taxation. In contrast, the mere assumption of the taxpayer's recourse liability may not result in the receipt of a measurable economic benefit. In *Estate of Weeden v. Commissioner*, 685 F.2d 1160, 1161 (9th Cir. 1982), the Commissioner successfully argued that the taxable event in *Diedrich* was not the donee's naked assumption of the donor's gift tax liability, but the donee's subsequent payment of the liability that resulted in a taxable economic benefit. Until that time, the assumption constituted nothing more than the donee's nonnegotiable promise to pay, which was not currently income to a cash method taxpayer. The donor received nothing of ascertainable fair market value which could be construed as an economic benefit.

Where the liability involved is a nonrecourse liability, it does not comport with economic reality to make third party payment of the liability the event triggering economic benefit to the taxpayer. Nonrecourse debt is associated with property; transfer of the property subject to the debt is sufficient to impose a taxable event: "the benefit to him is as real and substantial as if the mortgage were discharged, or as if a personal debt in an equal amount had been assumed by another." *Crane v. Commissioner*, 331 U.S. 1,14 (1947).

In a subsequent interpretation of *Crane*, this Court held that in the case of a transfer of property subject to nonrecourse debt, the seller's amount realized under 26 U.S.C. § 1001(b) (1982) included the face amount of the debt notwithstanding the fact that the fair market value of the property was less than the debt. *Commissioner v. Tufts*, 461 U.S. 308 (1983). In reaching this result, this Court observed that "*Crane* ultimately does not rest on its limited theory of economic benefit; instead, we read *Crane* to have approved the Commissioner's decision to treat a nonrecourse mortgage in this context as a true loan." *Ibid* at 307.

The Ninth Circuit in *Owen* mistakenly relied on this language in *Commissioner v. Tufts* to conclude that 26 U.S.C. § 357(c) (1982) finds "income" even in the absence of an economic benefit doctrine. *Owen v. Commissioner*, 881 F.2d 832, 836 (9th Cir. 1989). This misplaced reliance on the *Tufts* analysis of nonrecourse debt inappropriately transfers the same idea to recourse obligations. It is true that the inclusion of nonrecourse liabilities in the basis of the property acquired with such debt justifies inclusion of the liabilities in amount realized when the property is transferred. The nature of the nonrecourse liability is such that once the taxpayer disposes of the encumbered property the nonrecourse liability will trouble him no more. The debt is transferred with the property; the timing of the inclusion in income necessarily must be the date of the transfer.

But recourse liability is different. The taxpayers in *Tufts* surely would not have been deemed to have realized a taxable gain at the time of the transfer if they had given the lender a recourse note for \$395,760, the amount of gain from nonrecourse liabilities in excess of basis. The recourse obligation to the lender would offset the transferred excess liability, so that the taxpayers' net accretion in real wealth would be zero. There would be no economic benefit from the transfer, and thus no taxable gain.

Where recourse liabilities exist, the transfer of property subject to such liabilities and or transferee assumption of the liabilities without the release of the taxpayer from future payment clearly requires a result different from the result in a transfer of property subject to nonrecourse debt. The taxpayer has a continuing connection to the liability after the transfer. In recourse debt cases, as opposed to nonrecourse debt cases like *Tufts* and *Crane*, the taxpayer is expected to pay the liabilities.

Thus, when a taxpayer (as in *Lessinger*) has the continuing responsibility to pay the excess liabilities (or their equivalent) through a note to the corporation, no taxable economic benefit occurs at the time of the incorporation transfer, particularly where the corporation has a negative net worth. The scope of 26 U.S.C. § 357(c) (1982) should not be so broad as to tax nonexistent "income." If the taxpayer fails to pay the note, however, he will have income from the discharge of indebtedness under 26 U.S.C. § 61(a)(12).

The same analysis applies in the Petitioners' case. At the time of the McO transfers of equipment to Western on December 31, 1981, the market value of the equipment had fallen considerably below the liability of \$988,008 and arguably below the adjusted basis of the equipment of \$763,354. On September 2, 1982, the equipment was worth only \$750,000 and it was subsequently sold for considerably less. Owen and

McEachron knew that they personally would have to pay, out of their personal assets (including their \$100,000 certificate of deposit), the liabilities on the equipment above the value of the equipment. Western had no other assets with which to pay the liabilities and Owen and McEachron were personally liable on the debt. Had this not been the case, would the lender have permitted its collateral to be transferred to a shell corporation? Western had a negative net worth at the time of the 1981 transfer, just as in *Lessinger*. The Second Circuit correctly concluded that there was no economic benefit in *Lessinger* and the same result should be reached here.

These taxpayers did not receive the same kind of economic benefit as the taxpayers in *Tufts* and *Crane* who transferred property subject to nonrecourse debt. The Owens paid the recourse liabilities out of their own pockets and should not be taxed as if they had made money.

Finally, Petitioners' economic benefit argument is more compelling than that in *Lessinger*. In that case, the corporation, not the shareholder, eventually paid the transferred liabilities even though it had the shareholder's note. In Petitioners' case, Western never had the capacity to pay the transferred liabilities above the value of the equipment and Petitioners did not intend for Western to pay the liabilities. This economic reality is underscored by the lender's subsequent release of its security interest in the amount of the liabilities in excess of the equipment's value.

In a 1975 unpublished memorandum affirmance of the Tax Court, the Third Circuit approved the application of 26 U.S.C. § 357(c) (1982) in similar circumstances. *Rosen v. Commissioner*, 62 T.C. 11 (1974), *aff'd without published opinion*, 515 F.2d 507 (3d Cir. 1975). In *Rosen*, the taxpayer also transferred recourse liabilities to an insolvent corporation and remained personally liable on the transferred liabilities that

exceeded the adjusted basis of the equipment transferred. The Tax Court recognized the harshness of imposing a tax on a technical gain where none existed in an economic sense:

As the courts have sometimes remarked, section 357(c)(1) may produce a harsh result. *Peter Raich*, 46 T.C. 604 (1966); *Wilford E. Thatcher*, 61 T.C. 28 (1973). For that reason, wherever possible, the courts have sought to limit its application. *E.g.*, *Bongiovanni v. Commissioner*, 470 F.2d 921 (2d Cir. 1972), reversing a Memorandum Opinion of this Court. Section 357(c)(1) may even result in the realization of a gain for tax purposes where none in fact exists. However, the petitioner did not contend, and the Court is loathe to find, that the result exceeds the constitutional powers to tax vested in the Congress.

*Ibid* at 19.

Thus, the Ninth, Eighth and Third Circuits and the Tax Court have expressly or tacitly ruled that 26 U.S.C. § 357(c) (1982) imposes tax on income that does not exist in an economic sense. Although the income tax may permit economic income to go untaxed for reasons of administrative convenience or fiscal policy, no provision of the Internal Revenue Code should be interpreted to impose tax in the absence of an economic benefit. The Second Circuit, in its *Lessinger* decision, has correctly interpreted 26 U.S.C. § 357(c) (1982) to include excess liability "gain" in income only when there is "gain" in the economic sense.

### **III. Conflict With This Court's Basis Analysis**

Because of the interrelationship of 26 U.S.C. §§ 357(a) and 358(a) and (d) (1982), the Commissioner may in essence argue

that a failure to currently tax the amount of liabilities in excess of basis as a gain under 26 U.S.C. § 357(c) (1982) will create a negative basis in Petitioners' Western stock by the amount of the excess. Negative basis is arguably a result which 26 U.S.C. § 357(c) (1982) was at least in part designed to cure. *Lessinger v. Commissioner*, 872 F.2d 519, 527 (2d Cir. 1989).

In order to avoid the shareholder receiving a negative basis, the Second Circuit in *Lessinger* created a contorted and arguably incorrect analysis of the shareholder's stock basis. The Court reasoned that in order to avoid taxing the transferee corporation on income as Mr. Lessinger paid his note to the corporation, the corporation must have had a basis in the note. Recognizing that the corporation's basis in assets it receives is a carryover basis under 26 U.S.C. § 362(a) (1982), the Court was then forced to determine how the corporation achieved the note basis.

In this pursuit, the Second Circuit agreed with the long standing principle that a shareholder does not have a basis in his own note until the note is actually paid. See *Alderman v. Commissioner*, 55 T.C. 662 (1971); and *Rev Rul 68-629*, 1968-2 C.B. 154. Since the shareholder did not have a basis in his note at the time it was given to the corporation, the Second Circuit was faced with the uncomfortable task of determining the source of the mysterious basis. In resolving the issue, the Court concluded that what must have been intended in such circumstances is a "special shareholder basis" in the note that exists only under the auspices of 26 U.S.C. § 357(c) (1982) which transferred to the corporation and therefore was properly sourced with the shareholder in such a manner to apparently avoid the creation of a negative shareholder stock basis. *Ibid* at 526.

Unfortunately, like so many questions in tax law, the answer and result depend on the question asked. First, the Second

Circuit's basis analysis began with the erroneous assumption that, absent a basis in the note, the corporation would recognize income when it received payment. This is inaccurate as such payments are treated as nontaxable contributions to capital or proceeds from the sale of stock. 26 U.S.C. §§ 118 and 1032 (1982).

Second, the question is not whether the shareholder had a basis in the note but rather did the shareholder's stock basis under 26 U.S.C. § 358(a) (1982) reflect the liability incurred to acquire the stock. *Lessinger* and its equitable result will be the subject of criticism until this technical aspect of the case is explained. Petitioners contend that the explanation is found in this Court's basis analysis in *Crane* and *Tufts*.

If the language of 26 U.S.C. § 357(c) (1982) is interpreted broadly to find that all liabilities to which the equipment were subject are within the statute, the full amount of the liabilities will be treated as money and reduce the shareholder's stock basis under 26 U.S.C. §§ 358(a)(1)(A)(ii) and 358(d) to a negative figure equal to the amount by which the total liabilities exceed the adjusted basis of the assets transferred to the corporation. However, under *Crane* and *Tufts*, the shareholder should be entitled to a correlative basis increase for the amount of debt he created, retained or incurred in the transfer paid as consideration for the acquisition of the stock.

The general income tax treatment of debt associated with property transactions provides that taxpayers are not taxed on the receipt of borrowed funds because of the presence of an offsetting obligation to repay the debt. Where the borrowed funds are related to the acquisition of property, the taxpayer's basis in the new property includes the amount of the true debt. Generally, a taxpayer's basis in property includes only after-tax dollars and is designed to permit the taxpayer a tax-free recovery of those dollars on the disposition of the property. However, when debt is incurred with the acquisition of

property it is included in a property's basis as a result of the Commissioner's administrative practice designed to alleviate the problems associated with a depreciation system: predicated on periodic basis adjustments due to principal payments. *Commissioner v. Tufts*, 461 U.S. 300,305 (1983).

The idea is that when such acquisition debt is actually paid, it will be with nondeductible dollars and hence constitute a future basis increasing event. Thus, rather than have a series of basis adjustments associated with such repayments and depreciation deductions based upon the taxpayer's limited equity value, the Commissioner has preferred to simply accelerate the property basis increase at the moment the debt is incurred. The practice has now been firmly entrenched in our tax system through judicial reinforcement.

Accordingly, provided that the facts and circumstances surrounding the transfer establish that Petitioners actually had the economic responsibility for a debt incurred in connection with the acquisition of their Western stock, their basis should be increased. In *Lessinger*, the taxpayer delivered a new note in the transfer which should increase the stock basis. In this case, the facts clearly establish that Petitioners were personally liable on an amount of recourse debt, were not relieved of an amount of that debt as a result of the transfer which exceeded the amount of liabilities in excess of basis, and thus paid a portion of the liabilities in the future as consideration for the receipt of their stock.

Viewed in this way, the statutory language of 26 U.S.C. § 357(c) (1982) is not disturbed. Although the lender has a continuing security interest in the assets at the time of the transfer (which was released nine months later), the corporation is not expected to pay the liabilities in excess of basis. In this case the fair market value of the transferred equipment demonstrates that the lender never looked to the corporation for repayment in excess of the fair market value of the equipment.

As in *Lessinger*, Western had a negative net worth immediately after the transfer. Since the fair market value was below the adjusted basis of the equipment, it is obvious the lender was expecting the Owens and McEachrons to pay the balance of the recourse liabilities personally. The lender permitted the transfer only to enhance the selling price of the assets to be sold with the business and in fact released its security interest nine months after the transfer. The Owens and McEachrons personally paid more of the liabilities than the 26 U.S.C § 357(c) (1982) alleged "gain."

The *Crane* and *Tufts* basis argument cannot be distinguished because this case involves a nontaxable transaction. Even in a nontaxable exchange of like kind property under 26 U.S.C. § 1031 (1982), the taxpayer receives a basis increase for any net liability increase. See Treas. Reg. § 1.1031(d)-2(Example 2). In addition, the fact that 26 U.S.C. § 358(a) (1982) does not refer to such a basis increasing event is not controlling. The language of 26 U.S.C. § 1001(b) (1982) also does reflect that the release of debt will constitute an additional amount realized. Moreover, 26 U.S.C. § 1012 (1982) does not reflect that debt is included in "cost" basis. Traditionally, a basis increase for related acquisition debt has been a judicially developed doctrine as enunciated in *Crane* and *Tufts*.

Finally, as reflected in Appendix D, it is important to reinforce that Petitioners argument does not seek an elimination of the "gain" under 26 U.S.C. § 357(c) (1982). Petitioners argument is that the decision to tax be deferred until such time that it can be determined that Petitioners truly received the kind of economic benefit contemplated by the statute. At the same time, Petitioner's argument avoids the theoretical problems associated with the creation of a negative basis. Petitioners' argument also creates the singular advantage of taxing any gain realized in the future as ordinary income arising from the cancellation of debt. See *Commissioner v. Tufts*, 461 U.S. 300,317 (1983)(O'Connor, J., concurring opinion).

#### **IV. Importance of the Question to Ordinary Business Transactions**

It is difficult to imagine that taxpayers and their counsel actually plan for a recognition of gain under 26 U.S.C. § 357(c) (1982). Rather, it is probable that the issue only arises from either an unawareness of the statute or, as here, a failure to appreciate the fine points of the "subject to" language of the statute. In such cases, the statute encourages precisely the of kind activity engaged in by Petitioner's transaction counsel: creation of documents after the transfer that attempt to bring the form of the transaction in line with its substance. It is one thing to condition statutory benefits on strict form compliance; it is quite another to tax citizens on nonexistent income because the form of the transaction failed to reflect its substance, which did comply with the intent of the statute.

Transaction counsel for Petitioners did not create the most favorable form for the transfer of the McO equipment to Western. Nevertheless, the substance of the transfer, the facts surrounding the transfer, and the facts occurring after the transfer all clearly demonstrate that the Owens did not receive an economic benefit from this transaction and they should not be treated as if they had by a strict and unimaginative reading of the statutory language.

## **CONCLUSION**

The petition for Writ of Certiorari should be granted.

Respectfully submitted,

/s/ Carter G. Bishop

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November \_\_\_\_\_, 1989

**APPENDIX A**

**UNITED STATES COURT OF APPEALS  
For The Ninth Circuit**

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**No. 88-7026**

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**William F. and Gretchen K. Owen,  
Appellants,**

**v.**

**Commissioner of Internal Revenue,  
Appellee.**

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**Appeal from the United States  
Tax Court**

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**Submitted: December 5, 1988  
Filed: August 9, 1989**

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**Before HALL, WIGGINS and THOMPSON, Circuit Judges.**

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THOMPSON, Circuit Judge:

William and Gretchen Owen appeal the tax court's decision denying them certain investment tax credits and forcing them to recognize a taxable gain on a 1981 transfer of equipment. *Owen v. Commissioner*, 53 T.C.M. (CCH) 1480 (1987). We have jurisdiction under 26 U.S.C. § 7482. We affirm.

I

FACTS

Over the years, William Owen participated in several business ventures with Stephen McEachron. In 1977, they formed a general partnership called McO Investment ("McO"), in which they were equal partners. In 1980, Owen and McEachron entered the seismic drilling business. They borrowed money to buy drilling equipment, secured the loan by the equipment, gave their personal guaranties to the lender, and placed title to the equipment in McO. They then leased most of the equipment to Western Exploration, Inc. ("Western"), a corporation in which they had equal ownership interests.<sup>1</sup> Western conducted the seismic drilling operations.

The equipment leases from McO to Western generally were on a month-to-month basis, although some were modified to provide lease terms from day-to-day. None of the leases contained a fixed termination date. Each lease, however, was subject to cancellation by either party upon notice to the other of thirty days or twenty-four hours, depending on the type of lease used.

By 1981, the petroleum industry had suffered economic reversals, and Owen and McEachron decided to sell. Their

<sup>1</sup>Owen testified that although some equipment had been leased to third parties, such transactions were "relatively insignificant." *Owen*, 53 T.C.M. (CCH) at 1483-84 n. 15.

attorney advised them the best way to do that was to get the assets of the business into one corporate entity. So, in 1981, all of McO's assets were transferred to Western. At that time, the indebtedness secured by the assets exceeded the assets' adjusted basis.

The Commissioner of Internal Revenue disallowed investment tax credits which the Owens had taken on their 1980 income tax return for the purchase of the equipment which had been leased to Western. He concluded that the Owens were not entitled to the short-term lease exception of I.R.C. § 46(e)(3)(B). The Commissioner also assessed a capital gain tax against the Owens in their 1981 return based upon McO's transfer of the equipment to Western. The capital gain tax was calculated with reference to the amount by which the indebtedness secured by the equipment exceeded the equipment's adjusted basis on the date of the transfer. The Commissioner's position, relative to this appeal, was upheld by the tax court. The Owens appeal.

## II

### THE INVESTMENT TAX CREDIT

[1] Non-corporate lessors such as the Owens, who buy equipment and then lease it to another, may qualify for an investment tax credit provided that the term for which the property is leased out is less than fifty percent of the property's useful life. I.R.C. § 46(e)(3)(B) (1982) (later amended). We calculate the length of the lease by examining the "realistic contemplation" of the parties at the time the property is first put into service. *Hokanson v. Commissioner*, 730 F.2d 1245, 1248 (9th Cir.1984); see also *Connor v. Commissioner*, 847 F.2d 985, 989 (1st Cir.1988); *Ridder v. Commissioner*, 76 T.C. 867, 875 (1981). We review the tax court's decision that "the parties realistically contemplated that the leases would last" longer than fifty percent of the useful life of the property for clear error. *Hokanson*, 739 F.2d at 1249; *Connor*, 847 F.2d at 989.

First, the Owens contend we should reject the "realistic contemplation" test. They rely primarily on the three cases. Two cases, *Hoisington v. Commissioner*, 883 F.2d 1398, 1406 (10th Cir.1987), and *Miller v. Commissioner*, 85 T.C. 1064, 1072 (1985), are so clearly distinguishable that they do not warrant discussion. In the third case, *McNamara v. Commissioner*, 827 F.2d 168, 171-72 (7th Cir.1987), the Seventh Circuit rejected the "realistic contemplation test" which we embraced in *Hokanson*, 730 F.2d at 1248. We are bound, however, by *Hokanson*. Only an en banc court of this circuit can overrule it.

[2] Mindful of the *Hokanson* precedent, the Owens try to distinguish *Hokanson* on the basis that it involved a lease to an unrelated lessee. The Owens argue that the touchstone of the short-term lease exemption provided by I.R.C. § 46(e)(3)(B) is the concept that the purchaser of property who leases it to another is required to bear the economic risk attendant to ownership of the property for longer than the property's useful life to qualify for an investment tax credit. The Owens point out that in the present case Owen and McEachron were equal partners in the partnership that bought the equipment, and they were equal owners of the corporation to which it was leased. Thus, they assert, they bore the real economic risk of ownership of the property throughout its purchase and lease, and they should be entitled to the investment tax credits.

This argument asks that we reject the language of I.R.C. § 46(e)(3)(B) which tells us that the short-term lease exception depends upon the term of the lease. The Owens would have us interpret the ~~statute~~ to award investment tax credits based upon economic analysis of where the risk of ownership lies in a given transaction. We decline to do so. See *Connor*, 847 F.2d at 987-88 (following *Hokanson* and noting that administrative concerns prompted Congress to adopt a statutory test which excludes some legitimate lessors).

[3] The Owens further argue that the tax court clearly erred in finding that the parties to the leases realistically contemplated that the leases would last longer than fifty percent of the useful life of the property. We disagree. There is ample evidence in the record to support this finding by the tax court. See *Owen*, 53 T.C.M. (CCH) at 1483-84.

### III.

#### THE 1981 TRANSFER

[4] The tax court held that section 357(c)<sup>2</sup> requires the Owens to recognize a gain on the 1981 transfer the equipment from McO to Western. The court calculated the gain by subtracting the adjusted basis of the equipment from the total liabilities secured by the equipment on the date of the transfer.<sup>3</sup> The Owens argue that the tax court should have excluded liabilities secured by the property which they had personally guaranteed and for which they remained liable following the transfer. We disagree.

Under I.R.C. § 357(c), the Owens' continuing personal liability for the loans secured by the transferred equipment is irrelevant. "So long as the transferred property remains liable on the debt, then, such debt can be a section 357(c) liability even if the petitioner retained personal, unrelieved liability on it." *Smith v. Commissioner*, 84 T.C. 889, 909 (1985); see also *Beaver v. Commissioner*, 41 T.C.M. (CCH) 52, 54 (1980); *Rosen v.*

<sup>2</sup>Section 357 provides: (c) Liabilities in excess of basis.—(1) In general.—In case of an exchange—(A) To which section 351 applies, . . . if the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be. . . . I.R.C. § 357(c) (1988). The key issue on appeal is what qualifies as "liabilities to which the property is subject." *Id.*

<sup>3</sup>The tax court also gave the Owens credit for additional factors which are not relevant to the instant appeal.

*Commissioner*, 62 T.C. 11, 19 (1974), *aff'd without published opinion*, 515 F.2d 507 (3d Cir.1975).

First, the Owens ask us to reject the authority of *Smith*, *Rosen* and *Beaver*, and to hold that I.R.C. § 357(c) only applies where a taxpayer realizes an economic benefit from the transfer. We decline the Owens' invitation because section 357(c)'s plain language makes no special provision for transfer not resulting in an economic benefit to the transferor. *Cf. Commissioner v. Asphalt Products Co.*, 482 U.S. 117, 120-21, 107 S.Ct. 2275, 2277-78, 96 L.Ed.2d 97 (1987) (per curiam) (courts must give effect to the plain language of the internal revenue code); *Commissioner v. Tufts*, 461 U.S. 300, 307, 103 S.Ct. 1826, 1831, 75 L.Ed.2d 863 (1983) (taxpayer may realize a taxable gain under I.R.C. § 1001 even without receiving a net economic benefit from the transferee).

Second, the Owens claim that our decision *Jackson v. Commissioner*, 708 F.2d 1402 (9th Cir.1983) (per curiam), supports their assertion that section 357(c) only applies to transactions resulting in a gain cognizable under I.R.C. § 1001. *Jackson* offers no support for this argument. Indeed, in *Jackson*, we assumed that sections 351 and 357(c) were applicable despite our holding that section 1001's requirements for "a taxable transfer were not met." *Jackson*, 708 F.2d at 1404-05.

Third, the Owens assert that *Jackson* held that section 357(c)'s provisions do not apply to liabilities which are guaranteed by the transferor. We disagree. *Jackson* held that a partner did not have a section 357(c) gain when he transferred his partnership interest to his wholly owned corporation even though his share of the joint venture's liabilities exceeded his adjusted basis in the partnership loans after the transfer of the partnership interest. *Id.* at 1404-05; *id.* at 1406 (Duniway, J., concurring and dissenting). In *Jackson*, the taxpayer remained liable on the partnership interest. The Owens claim that *Jackson* stands for the proposition that a taxpayers' continued liability

for loans secured by the transferred property prevents the Commissioner from treating the loans as section 357(c) liabilities. The Owens suggest that *Jackson* rejected, *sub silentio*, the holdings of *Rosen* and *Beaver*. We conclude that *Jackson* is distinguishable.

*Jackson* involved the transfer of an interest in an ongoing partnership, and the interest was not encumbered by any liabilities. Thus, the property, *i.e.*, the partnership interest, transferred was not "subject to" a liability which could trigger a section 357(c) gain. The case presently before us involves the transfer of equipment which the tax court found to be subject to substantial liabilities in excess of the equipment's adjusted basis. In such a case, section 357(c) applies.<sup>4</sup>

Furthermore, *Jackson* was decided without the benefit of the Supreme Court's opinion in *Commissioner v. Tufts*, 461 U.S. 300, 307, 103 S.Ct. 1826, 1831, 75 L.Ed.2d 863 (1983). *Tufts* and *Jackson* were published at approximately the same time. Relying in part on dicta from *Crane V. Commissioner*, 331 U.S. 1, 67 S.Ct. 1047, 91 L.Ed. 1301 (1947), *Jackson* concluded that section 1001, and the tax system as a whole, require that the transferor receive "economically significant consideration." *Jackson*, 708 F.2d at 1404. *Tufts* clarified the scope of *Crane* and rejected *Crane's* "limited theory of economic benefit." *Tufts*, 461 U.S. at 307, 103 S.Ct. at 1831. *Tufts* undercuts the authority supporting the *Jackson* decision.

Fourth, the Owens contend that section 357(c)'s categories of (1) assumed liabilities and (2) liabilities to which the transferred property is subject are mutually exclusive. They assert that the latter category only applies to nonrecourse, unassumable liabilities. We disagree. The tax court decisions

<sup>4</sup>In *Jackson*, we did not consider whether any property of the partnership was used to secure the loans. *Cf. Smith*, 84 T.C. at 910 (partnership interests "were in substance" subject to the section 357(c) liabilities which were secured by the partnership's real property).

in *Smith*, *Rosen* and *Beaver* applied section 357(c) to recourse liabilities secured by the transferred property. *Smith*, 84 T.C. at 909; *Rosen*, 62 T.C. at 19; *Beaver*, 41 T.C.M. (CCH) at 54; see also Treas.Reg. § 1.357-2 (1988) (section 357(c) gain will occur "whether or not the liability is assumed by the transferee"). We hold that section 357(c) applies to recourse liabilities to which the transferred property is subject even if the transferor remains subject to the liabilities following the transfer.

Finally, the Owens contend that the tax court erred by failing to apply the step transaction doctrine to treat post-transfer documents prepared in June or July 1982 as retroactive to the December 31, 1981 equipment transfer. The tax court declined to apply the step transaction doctrine because it found that the 1982 agreements were not part of a single, integrated scheme relating back to the December 31, 1981 transfer. See *Owen*, 53 T.C.M. (CCH) at 1485-86. We cannot say that the tax court's finding on this issue is clearly erroneous.

AFFIRMED.

**APPENDIX B**

**T.C. Memo. 1987-375  
UNITED STATES TAX COURT**

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**Nos. 26790-84 and 26791-84**

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**William F. and Gretchen K. Owen,  
Stephen B. and Mary Jane McEachron,  
Petitioners,**

**v.**

**Commissioner of Internal Revenue,  
Respondent.**

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**Filed: July 28, 1987**

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**MEMORANDUM FINDINGS OF FACT AND OPINION**

GERBER, *Judge*: Respondent determined deficiencies in Federal income taxes in these consolidated cases<sup>1</sup> as follows:

Docket No.	1979 <sup>2</sup>	1980	1981
26790-84 .....	\$563.32	\$33,810.12	\$57,913.92
26791-84 .....	\$797.00	\$33,900.26	\$52,330.01

After concessions, the issues for our consideration are whether petitioners are entitled to investment tax credits under section 46(e)(3)(B)<sup>3</sup> in 1980 and 1981, and whether they must recognize gain under section 357(c), concerning a 1981 equipment transfer, pursuant to section 351.

### FINDINGS OF FACT

The parties have stipulated some of the facts and their stipulation of facts and attached exhibits are incorporated herein by this reference. William F. and Gretchen K. Owen, husband and wife at all times relevant to this case, resided in Los Angeles, California, at the time their petition was filed. They timely filed joint Federal income tax returns for the years 1980 and 1981. Stephen B. and Mary Jane McEachron, husband and wife at all times relevant to this case, resided in Long Lake, Minnesota, at the time their petition was filed. They timely filed join Federal income tax returns for the years 1980 and 1981.<sup>4</sup> For convenience, we sometimes refer to petitioner, William F. Owen, as "Owen," and to petitioner, Stephen B. McEachron, as "McEachron;" and collectively, we sometimes refer to Owen and McEachron as petitioners.

<sup>1</sup>These cases were consolidated for purposes of trial, briefing and opinion, by a Motion to Consolidate granted Oct. 18, 1984.

<sup>2</sup>Due to concessions by petitioners, taxable year 1979 is no longer in controversy.

<sup>3</sup>Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the years at issue. All rule references are to the Tax Court Rules of Practice and Procedure.

<sup>4</sup>The McEachrons filed a Form 1040X, amended joint income tax return, for 1980.

Owen and McEachron have been involved in several business ventures. In 1977, they organized McO Investment (McO) as a general partnership, of which they each held a 50-percent interest. McO's principal business was investing in real estate ventures.

Sometime around 1980, petitioners decided to enter the seismic drilling operation business.<sup>5</sup> Petitioners first attempted to purchase an ongoing concern and eventually decided to start their own seismic drilling business. Petitioners consulted Nick Hay (Hay), a tax specialist, seeking advice on how to structure the business. Petitioners structured the seismic drilling business by placing the equipment in McO and causing Western Exploration, Inc. (Western), to conduct operations. Western (which was owned equally by petitioners) was organized January 1, 1980, under the laws of Minnesota, and during 1980 and 1981, was a Subchapter C corporation.<sup>6</sup> Petitioners chose to have McO own the equipment and Western conduct the operations because (1) petitioners would be entitled to the investment tax credit and the depreciation associated therewith, and (2) the corporation would provide some measure of insulation in case of a catastrophe. Pursuant to this arrangement, McO and Western entered into several lease agreements. Generally, the leases were either on a month-to-month basis, or for indefinite terms, and provided that either party could cancel by giving advance notice.<sup>7</sup> McO financed the purchase

<sup>5</sup>The seismic drilling business is a type of geophysical exploration. Essentially, the business involves drilling a number of shallow holes on a mineral property and then determining whether or not an oil reserve is present.

<sup>6</sup>Petitioners each owned 50 percent of Western Companies, Inc. (WCI), a corporation organized under North Dakota law, and in the business of providing consulting services for the acquisition and disposition of businesses.

<sup>7</sup>Various pieces of equipment were covered by different leases. The leases provided for differing notice periods, and some required written notice. The equipment rental charge was \$6,000 per month under some agreements and \$7,500 per month under others. Some of the lease agreements were modified by a letter dated Dec. 28, 1980 (but not effective until Feb. 1, 1981), such that a daily rental of \$260.87 (with a maximum of \$6,000 per month) would be charged and the notification of cancellation period would be reduced to 24-hours notice.

of the equipment<sup>8</sup> largely by obtaining loans from Wayzata Bank and Trust Co. (Wayzata Bank).<sup>9</sup> In some of the loan proposals, petitioners presented McO's and Western's consolidated income and cash-flow statements to Wayzata Bank.

In addition to the equipment, in which Wayzata Bank has a security interest<sup>10</sup> in connection with a loan agreement dated May 26, 1981,<sup>11</sup> petitioners pledged a \$100,000 certificate of deposit as additional collateral on the indebtedness.<sup>12</sup> Petitioners, in connection with the same loan agreement, personally guaranteed the entire indebtedness.

The oil boom of the late 1970's began faltering around 1981 and petitioners experienced problems servicing their debt. At about the same time, the equipment began to decline in value. In order to abate the potential for substantial McO losses, petitioners decided to sell their seismic drilling business. Sometime around November or December 1981, petitioners met with Hay to discuss disposition of the business. Petitioners decided that transferring McO's assets to Western and then

<sup>8</sup>McO acquired various pieces of equipment in 1980 and 1981, as detailed in Appendix A of this opinion. McO purchased the equipment after Western Exploration, Inc. (Western), entered into contracts under which specific equipment would be needed.

<sup>9</sup>Petitioners were considered to be significant bank customers, and individually had large deposits in Wayzata Bank and Trust Co. (Wayzata Bank).

<sup>10</sup>The parties have agreed that Wayzata Bank possessed a "security interest" in the equipment. The dispute here concerns only the extent to which such security interest was transferred.

<sup>11</sup>On May 26, 1981, petitioners entered into an agreement consolidating two prior outstanding loans; in the amounts of \$300,463.41 and \$303,375.93, and a new loan in the amount of \$404,800, for a total consolidated loan of \$1,008,639.34. On May 29, 1981, Wayzata Bank entered into a security agreement covering the equipment at issue. On May 26, 1981, etotopmers amd Wayzata Bank also obtained a \$100,000

certificate of deposit as additional collateral on the above noted loans. On Aug. 5, 1981, McO entered into a Security Agreement with Wayzata Bank pledging the \$100,000 certificate of deposit.

<sup>12</sup>Wayzata Bank viewed the certificate of deposit as reducing the total outstanding indebtedness, and in fact, made informal notations reflecting the certificate of deposit on the various certificates of title related to the equipment.

selling the business as a single entity offered the most attractive way to dispose of the business. Petitioners realized, however, that McO's outstanding indebtedness exceeded McO's adjusted basis in the property. In order to avoid a potential Federal income tax problem, petitioners met with bank officials and discussed the possibility of the bank reducing its security interest in the equipment.

On December 31, 1981, the petitioners transferred substantially all of the equipment to Western. There was no contemporaneously written documentation regarding this transfer. A "Third Party Pledge Agreement," dated December 30, 1981, between Western and Wayzata Bank, apparently granted the latter a security interest in the equipment transferred.<sup>13</sup>

At the time of transfer, the aggregate unpaid principal balance on the consolidated loans payable to Wayzata Bank was \$988,008.48. McO's books reflected an adjusted basis in the equipment of \$781,862.23. In his notice of deficiency, respondent determined an adjusted basis in the equipment of \$763,354.23.

Respondent began his examination in April 1982. On or about June 24, 1982, the Internal Revenue agent conducting the audit requested documentation regarding the December 31, 1981, transfer. During June or July 1982, a "Transfer agreement" purportedly governing the equipment transferred on December 31, 1981, was drafted. That agreement reflected that "as of this 31st day of December, 1981," Western agreed to pay and assume \$781,862.23 of the indebtedness incurred by McO to purchase the equipment. Western also agreed to indemnify McO against claims arising out of the agreement, the equipment or use of

<sup>13</sup>Schedule A to this agreement, the list of equipment secured was not offered into evidence by the parties. An identical Third Party Pledge Agreement, dated Mar. 22, 1982, was offered and received. The Mar. 22, 1982, agreement contains a schedule listing the equipment secured, which we assume is the same as the Dec. 30, 1981, Schedule A, or that it would have had no effect on the outcome of this matter.

the equipment. An "Agreement" between McO and Western, also drafted in June or July 1982, purportedly modified the Transfer agreement. This modifying agreement also reflected that it was "as of this 31st day of December, 1981." It further noted that the equipment transferred was "security for certain purchase money indebtedness in an amount in excess of the indebtedness assumed by Western" and that Western would not "assume any of said indebtedness in excess of \$781,862.23, it being expressly agreed by and between the parties that any said indebtedness in excess of the amount assumed by Western, shall be the sole obligation of McO." The Internal Revenue agent received the Transfer agreement and modification of July 14, 1982.

The Transfer agreement and the agreement modifying it were executed, apparently, around September 1982. On September 3, 1982, Wayzata Bank released part of its security interest in the equipment. The total outstanding indebtedness to Western was restructured to provide that Owen and McEachron individually assumed person liability for a portion of the indebtedness. On September 2, 1982, McEachron had reached an agreement to sell his 50-percent interest in Western to Mountain States Seismic Service, Inc., an unrelated party. This agreement appears to have been made with the condition that McEachron's portion of the indebtedness be reduced to reflect the estimated value of the equipment (\$750,000).

## OPINION

The first issue for our consideration is whether petitioners are entitled to an investment tax credit. The sole dispute concerning this issue is whether petitioners satisfy section 46(e)(3)(B).

Section 38 allows a credit against tax for investments in certain depreciable property in an amount determined under section 46. In pertinent part, section 46(e)(3) provides:

(e) Limitations with Respect to Certain Persons.—

\*\*\*

(3) Noncorporate lessors.—A credit shall be allowed by section 38 to a person which is not a corporation with respect to property of which such person is the lessor only if—

\*\*\*

(B) the term of the lease (taking into account options to renew) is less than 50 percent of the useful life of the property.

\*\*\*

Petitioners bear the burden of proving that the leases were for less than 50 percent of the useful lives of the properties. *Welch v. Helvering*, 290 U.S. 111 [12 AFTR 1456] (1930); Rule 142(a).<sup>14</sup>

In determining whether the lease is of an indefinite duration for purposes of section 46(e)(3)(B), all pertinent facts and circumstances should be considered. *Highland Hills Swimming Club, Inc. v. Wiseman*, 272 F.2d 176 [4 AFTR2d 5935] (10th Cir. 1959); *Buddy Schoellkopf Products, Inc. v. Commissioner*, 65 T.C. 640, 656-(1975). The length of a lease term is determined by the "realistic contemplation" of the parties at the time the lease was entered into. *Hokanson v. Commissioner*, 730 F.2d 1245, 1248 [53 AFTR2d 84-763] (9th Cir. 1984), *affg.* a Memorandum Opinion of this Court. If there is reasonable certainty that the lessee will continue leasing the property beyond the period stated in the lease, the lease term is considered indefinite. *G.W. Van Keppel Co. v. Commissioner*, 295 F.2d 767, 770-771 [8 AFTR2d 5702] (8th Cir. 1961), *affd.* a Memorandum Opinion of this Court. The actual duration of the lease is not necessarily determinative. *Ridder v. Commissioner*, 76 T.C. 867, 875, (1981); *Bloomberg v. Commissioner*, 74 T.C. 1368, 1371 (1980).

<sup>14</sup>*Sanders v. Commissioner*, T.C. Memo. 1984-511 [par. 84,511 PH Memo TC], *affd.* without published opinion 770 F.2d 174 (11th Cir. 1985).

Petitioners contend that they intended to (and in fact did) lease equipment to third parties and, in any event, that they were advised that they must terminate the leases prior to the expiration of 50 percent of the useful life of the equipment, and accordingly planned to (and actually did) transfer the equipment before such time. Respondent maintains, that from the inception of the leases, petitioners did not "realistically contemplate" leasing the equipment to third parties, and accordingly, are not entitled to the investment tax credit. Respondent also contends that the transfers were not before the expiration of 50 percent of the useful life of the equipment, and that in any event, actual transfer is not determinative.

This issue is a factual matter, and based on the entire record, we agree with respondent. Upon deciding that they would enter the seismic drilling market, petitioners consulted with professional advisors about the best way to structure the contemplated business. They decided to form a corporation in which the business operations would lie, and to purchase the equipment used in the operation through a pre-existing partnership. This would accomplish the dual purpose of insulating petitioners from personal liability in the event of a catastrophe and enable them to benefit individually through depreciation deductions and the investment tax credit.

Apparently, McO only purchased equipment specifically tailored to Western's anticipated needs. Petitioners obtained loans from Wayzata Bank to finance such purchases; petitioners gave the bank a security interest in the equipment and later also personally guaranteed the loans. In obtaining some of the loans, petitioners presented Wayzata Bank with loan proposals containing consolidated statements of income and loss for McO and Western.

McO and Western entered into several leases involving the equipment. The leases were either month-to-month or for indefinite periods. Either party could cancel a lease upon proper

notice. Most of the loan documentation with Wayzata Bank reflected total revenues equal to revenues expected from the equipment rental to Western. There is nothing in the record that indicates that Western contemplated renting equipment from anyone but McO and that petitioners intended to lease the equipment to anyone other than Western, so long as Western could use the equipment.

Petitioners testified that they intended to and did lease the equipment to lessees other than Western.<sup>15</sup> We find, however, that the circumstances surrounding the equipment acquisition are more indicative of petitioners' intent than their self-serving testimony. Cf. *Siegel v. Commissioner*, 78 T.C. 659, 699 (1982).

Petitioners also argue that the equipment was actually transferred; that some transfers were before the expiration of 50 percent of the assets useful life,<sup>16</sup> and as such that they

<sup>15</sup>Owen testified that a drilling rig had never been leased to third parties, but that some equipment (i.e., water or pickup trucks) had been leased to employees or other third parties. Owen could not recall the amounts or dates of any such rentals, produce any documentation supporting such leases, and termed such transactions as "relatively insignificant."

<sup>16</sup>Generally, for investment tax credit purposes, the useful life of property is determined with reference to sec. 167 or sec. 168. See sec. 46(c)(2) and sec. 46(e)(3). McO utilized useful life and class life periods of five and three years in computing the depreciation. Citing *Corkery v. Commissioner*, T.C. Memo 1985-311 [par. 85,311 PH Memo TC], and *Fredricks v. Commissioner*, T.C. Memo 1983-725 [par. 83,725 PH Memo TC], respondent argues that because petitioners were advised to sell the equipment prior to the expiration of 50 percent of its useful life, for purposes of sec. 46(e)(3), the useful life of the equipment is limited to the actual time period that petitioners owned the equipment. The record supports the conclusion, however, that the equipment transfer (to the lessee) was made because of unforeseeable circumstances, in an attempt to integrate the business before selling it as a whole. Because of our conclusions, *infra*, we do not have to give consideration to this argument.

should be allowed the investment tax credit.<sup>17</sup> Even assuming that petitioners' contention was correct (i.e., that a party who planned to transfer equipment prior to the exploration of 50 percent of its useful life and actually did, would not be denied an investment tax credit in this 46(e)(3)(B)) the equipment transfer in this case was a sale to an entity wholly owned by petitioners, which resulted from an unforeseeable event.<sup>18</sup>

Finally, petitioners contend that they considered the issue at hand in structuring the transaction; sought to avoid any adverse tax problems; and as such should be allowed the claimed benefit. Again, we must disagree. We would expect petitioners, as sophisticated businessmen, to seek to minimize tax consequences and maximize the economic benefits of business ventures. Acknowledgment of a tax problem and appropriate action to avoid or cure the problem are not one in the same. Under the circumstances of this case, we conclude that the leases were for indefinite time periods.

The only other issue for our consideration is whether petitioners must realize gain on the transfer of assets from McO

<sup>17</sup>Even assuming that the useful life of the equipment was five or three years as claimed, the parties disagree as to whether the equipment was transferred prior to the expiration of 50 percent of such time. The terms of some original leases were modified by letter dated Dec. 28, 1980 (see note 8, *supra*), and petitioners interpret this letter as cancelling the original leases and creating new leases between the parties. Petitioner does not aggregate the time period for the original and "modified leases," and argues that all leases were for less than 50 percent of the useful life of the property. We disagree with petitioner on both grounds. First, the letter modification of the original leases was just that. The letter states that the original agreements were to remain in effect, except as noted. This does not amount to cancellation of a lease for purposes of sec. 46(e)(3)(B). Even if it did, under these circumstances it would be appropriate to aggregate the lease terms. We note that this issue is not determinative in any event.

<sup>18</sup>Of course we realize that in some areas a transaction between related entities will not be respected when that transaction is adopted solely for tax motivated reasons. We also note that intent to qualify for benefits under sec. 46(e)(3) is not determinative (compare *Sallies v. Commissioner*, 83 T.C. 44 (1984); the test is "reasonable contemplation" that the property will be leased to third parties.

to Western. Section 351(a) generally provides that no gain or loss shall be recognized where property is transferred to a corporation. The assumption of a liability will not disqualify the transaction from section 351 treatment. Section 357(c)(1), however, requires recognition of gain to the extent that "the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds the total of the adjusted basis of the property transferred." So long as the transferred property is subject to the debt, it will constitute a section 357(c) liability, regardless of whether petitioners were personally liable on the debt. See *Smith v. Commissioner*, 84 T.C. 889 (1985), *affd.* per order 805 F.2d 1073 (D.C. Cir. 1986), citing *Rosen v. Commissioner*, 62 T.C. 11, 19 (1974), *affd.* without published opinion 515 F.2d 507 (3rd Cir. 1975); *Lessinger v. Commissioner*, 85 T.C. 824, 837 (1985), on appeal (2d Cir, March 29, 1987).

Petitioners contend that, at the time of transfer, they had an oral agreement with Wayzata Bank releasing any security interest in the transferred equipment which exceeded such equipment's adjusted tax basis, and that such agreement was reduced to written form nine months after the transfer was completed. Petitioners argue that this position is supported by (1) their books and records, and (2) the fact that they were conscious of a potential section 357(c) problem prior to the transfer and actively sought to avoid such problem.<sup>19</sup> Petitioners also contend that under Minnesota state law, Western did not assume the liabilities of McO. Petitioners, in the alternative argue that any calculation of section 357(c) gain should be reduced by the \$100,000 certificate of deposit pledged as security on

<sup>19</sup>Petitioners attempt to analogize the issue at hand to issues presented concerning "subject to" and "assumptions" of debts and "wrap-around mortgages" under sec. 453. Petitioners contend that sec. 453, in a *Hunt v. Commissioner*, 80 T.C. 1126 (1983), situation, permits a seller to remain independently liable for the "wrapped" indebtedness. In so doing, however, sec. 453 governs only *when* gain is to be recognized not the *amount* of gain to be recognized. Sec. 357(c), on the other hand, operates to cause recognition of an *amount* of gain.

the indebtedness. Respondent argues that in December 1981: (1) The equipment was security for the full amount of indebtedness; (2) petitioners did not have any agreement with Wayzata Bank releasing any security interest in the transferred equipment; (3) petitioners' personal assumption of a portion of Western's indebtedness in September 1982, is irrelevant herein; and (4) McO did not transfer the \$100,000 certificate of deposit to Western. Except for the last contention, we agree with respondent.

On December 31, 1981, McO transferred equipment with an adjusted basis of \$763,354.23 to Western.<sup>20</sup> As of that date, the unpaid principal balance of the loans obtained to purchase the equipment transferred was \$988,008.48. As of December 31, 1981, there was no release of any part of Wayzata Bank's security interest in the equipment.

In September 1982, Wayzata Bank released part of its security interest in the equipment. The total outstanding indebtedness to Western was restructured to provide that Owen and

<sup>20</sup>Apparently, the discrepancy between the adjusted basis per McO's books (\$781,862.23) and as determined by respondent in his notice of deficiency (\$763,354.23) resulted from a change in 1981 to the ACRS recovery period for pick-up trucks from five years to three years. Petitioner has not placed in dispute respondent's determination of McO's adjusted basis in the equipment, and accordingly we find that McO's adjusted basis in the equipment transferred to Western is \$763,354.23 as determined by respondent. See Rule 142(a); *Welch v. Helvering*, 290 U.S. 111 [12 AFTR 1456] (1933).

McEachron individually assumed personal liability for a portion of the indebtedness.<sup>21</sup>

- Petitioners urge that the restructuring should be considered to retroactively take effect on December 31, 1981. Respondent argues that petitioners have failed to prove their alleged intent and that Wayzata Bank's understanding was as petitioners claim. Respondent offers, as an alternative reason for the restructuring, McEachron's September 2, 1982, agreement to sell his 50-percent interest in Western to Mountain States Seismic Service, Inc., an unrelated party. This agreement apparently was on the condition that McEachron's portion of the indebtedness be reduced to reflect the estimated value of the equipment (\$750,000).

The record does not support petitioners' contention that as of December 31, 1981, an oral agreement existed between petitioners and Wayzata Bank reducing the indebtedness to which the equipment was subject. Petitioners' self-serving testimony is generally unsupported in the record. Although we may consider books and records to be reflective of a transaction,

<sup>21</sup>Berg testified as follow:

Q. [A]re you aware of the transaction with the bank whereby the note was bifurcated to provide the Western \*\*\* was only responsible for approximately \$780,000 of the indebtedness, and the remaining indebtedness was split equally between Owen and McEachron?

A. Yes, I am aware of that.

\*\*\*

Q. In essence, do those three copies of the notes [dated September 3rd, 1982] represent the transaction whereby the loan was bifurcated in the fashion described in the previous testimony.

A. I'm sorry I didn't look at the second and third pages. They indicate a loan to Steve McEachron of 102,913 and a similar amount to Bill Owen, and that indicates how we restructured the debt.

Q. Mr. Berg, what was your understanding with regard to the purpose of this restructuring?

A. Well, the understanding was Mr. Owen and Mr. McEachron came to us and asked if individually they could assume portions of the overall indebtedness indicated on those notes, the 102,000 each, and we said, yes, and therefore the obligation of Western \*\*\* was reduced to \$780,000.

they may be accorded little probative weight and are not necessarily determinative,<sup>22</sup> especially here where the evidence reflects that the "recorded event" had not taken place.

The fair market value of the equipment as of December 31, 1981, and September 1, 1982, is not ascertainable from the record. Wayzata Bank may have been less likely to reduce its security interest in the equipment at the earlier date, and Berg stated that the security interest was not reduced until September 1982.

We find petitioners' contention that the September 1982 agreements should be treated as retroactive to December 1981 to be without merit. Although the "step transaction doctrine" is available to taxpayers in appropriate circumstances, the steps should be part of a single transaction if they are to be part of an integrated scheme.<sup>23</sup> Under the facts of this case, the step transaction doctrine does not afford relief to petitioners. Petitioners provided documentation concerning the December 31, 1981, equipment transfer which was prepared after respondent began his audit and requested documentation. The Internal Revenue agent conducting the audit requested information around June 24, 1982, and received the Transfer agreement and modification on July 14, 1982. Hay testified that the agreements were prepared sometime in June or July of 1982, and the loan bifurcation was not executed until September 2, 1982. We find that timing of the drafting of the agreements does not support petitioners' position. Cf. *Hoover Co. v. Commissioner*, 72 T.C. 206, 248 (1979); *Legg v. Commissioner*, 57 T.C. 164, 169 (1971), *affd. per curiam* 496 F.2d 1179 [33 AFTR2d 74-1343] (9th Cir. 1974); *Acro Manufacturing Co. v. Commissioner*, 39 T.C. 377, 385 (1962), *affd.* 334 F.2d 40 [14 AFTR2d 5106] (6th Cir. 1964), *cert. denied* 379 U.S. 887 (1964).

<sup>22</sup>Compare *Burwell v. Commissioner*, T.C. Memo. 1985-583 [par. 85,583 PH Memo TC].

<sup>23</sup>For example, see *Yamamoto v. Commissioner*, 73 T.C. 946, 953 (1980), *affd.* 672 F.2d 924 [Unpublished order dated 1-7-82] (9th Cir. 1982).

Wayzata Bank first agreed to the reduction of the security interest in September 1982. Under these circumstances, we conclude that the purported Transfer agreement and modification thereof were not part of the December 1981, equipment transfer, and accordingly should not be treated retroactively or as part of a step transaction.

Finally, we dismiss petitioners' contention that under Minnesota state law, the property in question passed without Wayzata Bank's security interest. We do not need to discuss whether these circumstances fit one of the exceptions to Minnesota state law which provides, generally, that a transferee is not liable for the debts and liabilities of the transferor,<sup>24</sup> because all that is necessary under section 357(c) is that the property remain subject to the debt. There is no dispute about the fact that the equipment was subject to Wayzata Bank's security interest. Petitioners' argument is that the security interest in the amount in excess of basis was not transferred; petitioners contend that the security interest in excess of basis disappears. Minnesota state law does not support this bifurcation.

We agree with petitioners, however, that the \$100,000 certificate of deposit should be offset against the gain determined under section 357(c). In May 1981, petitioners pledged the certification of deposit as additional security for the indebtedness.<sup>25</sup> Although the certificate of deposit was a personal asset of petitioners, rather than an asset of McO's,

<sup>24</sup>Although Minnesota state law provides, generally, that a transferee is not liable for the debts and liabilities of the transferor, the general rule is inapplicable, *inter alia*, where the transferee expressly or impliedly agrees to assume the transferor's debts and liabilities. *J. F. Anderson Lumber Co. v. Myers*, 296 Minn. 33, 206 N.W. 2d 365, 368 (1973); see also Minn. Stat. section 302A.661 (1984).

<sup>25</sup>At the same time, petitioners also personally guaranteed the indebtedness. This personal guarantee is not effective to increase their basis in the transferred assets or otherwise affect any gain determined under sec. 357(c). See *Rosen v. Commissioner*, 62 T.C. 11 (1974), *affd.* without published opinion 515 F.2d 507 (3d Cir. 1975).

we conclude that such offset is appropriate because: (1) the record indicates that Wayzata Bank accepted such certificate of deposit as a reduction in the face amount of the outstanding indebtedness, and (2) notations on various certificates of title apparently included such certificate of deposit in computing total outstanding indebtedness.

To reflect the foregoing,

*Decisions will be entered under Rule 155.*

## APPENDIX A

Description	Date Acquired	Cost
Drilling Rigs:		
D10 .....	6/1/80	\$156,163
D20 .....	6/1/80	155,056
D30 .....	7/10/80	152,612
D40 .....	7/10/80	156,273
D50 .....	5/71	174,965
D60 .....	5/81	174,965
Total		<u>\$970,034</u>
Water Trucks:		
W11 .....	6/1/80	34,939
W21 .....	6/7/80	34,939
W31 .....	6/1/80	34,939
W41 .....	6/19/80	34,939
W51 .....	5/81	—
W61 .....	5/81	—
W71 .....	5/81	—
W81 .....	5/81	123,612
Total		<u>\$263,368</u>
Pick-Up Trucks and Miscellaneous:		
P12 .....	3/5/80	7,512
P22 .....	3/5/80	7,512
Misc. ....	3/80	1,644
P32 .....	5/80	7,631
P42 .....	5/80	7,631
Misc. ....	6/80	1,276
Blazer .....	5/80	3,000
P52 .....	4/81	—
P62 .....	4/81	—
Misc. ....	4/81	18,556
Total		<u>\$ 54,762</u>

Total Equipment Cost\*

\*Includes a round error of \$4. [See Ex. 12-L and 16-P]



**APPENDIX C**

**UNITED STATES COURT OF APPEALS  
For The Eighth Circuit**

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**No. 88-1176**

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**Stephen B. and Mary Jane McEachron,  
Appellants,**

**v.**

**Commissioner of Internal Revenue,  
Appellee.**

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**Appeal from the United States  
Tax Court**

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**Submitted: October 20, 1988  
Filed: November 30, 1988**

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**Before HEANY and FAGG, Circuit Judges, and  
HENLEY, Senior Circuit Judge.**

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FAGG, Circuit Judge.

Stephen B. McEachron and Mary Jane McEachron appeal the Tax Court's decision confirming federal income tax deficiencies assessed for 1980 and 1981 against them and two other taxpayers by the Commissioner of Internal Revenue (the Commissioner). See *Owen v. Commissioner*, 53 T.C.M. (CCH) 1480 (1987). The Tax Court held the McEachrons were not entitled to an investment tax credit for equipment leased to a related corporation by a business in which Mr. McEachron was a partner. The court also held the McEachrons were required to recognize gain on the later sale of the leased equipment by the partnership to the corporation. We affirm.

Mr. McEachron and an unrelated taxpayer formed a two-tiered business to engage in seismic drilling. One tier was formed as an equal partnership, and the other was a corporation with stock ownership divided equally between Mr. McEachron and the other taxpayer. The partnership owned the drilling equipment and leased it to the corporation, which conducted the actual exploration operations. When the business faltered, the owners decided to transfer the equipment from the partnership to the corporation and sell both companies as a single unit. The equipment leases and ownership transfer give rise to the dispute in this case.

[1] On appeal, the McEachrons first challenge the Tax Court's disallowance of the investment tax credit. The Tax Court found the leases between the partnership and the corporation were for an indefinite term and thus failed to satisfy the fifty percent useful life requirement of 26 U.S.C. § 46(e)(3)(B) (1976). See *Owen*, 53 T.C.M. at 1483-84. The McEachrons argue the Tax Court improperly used the "realistic contemplation" standard for evaluating the useful life requirement and, that even if the standard is appropriate in these circumstances, the resulting finding of fact was clearly erroneous. We disagree.

[2] When the challenged leases are for an indefinite term, we see no reason to depart from the realistic contemplation concept in determining whether the fifty percent useful life requirement is met. Other circuits agree with this view. See *Connor v. Commissioner*, 847 F.2d 985, 989 (1st Cir.1988); *Hokanson v. Commissioner*, 730 F.2d 1245, 1248 (9th Cir. 1984). The McEachrons' reliance on *McNamara v. Commissioner*, 827 F.2d 168, 170-72 (7th Cir.1987), is misplaced. The leases in *McNamara*, unlike those under consideration here, expressly provided for fixed lease terms lasting less than fifty percent of the property's useful life. See *id.* at 170. We have reviewed the record on this issue and agree with the Tax Court that the leases here do not meet the requirements permitting the McEachrons to claim an investment tax credit for the leased equipment. See *Owens*, 53 T.C.M. at 1483-84.

[32] The McEachrons next argue they should not be required to recognize a gain on the sale of the equipment because the liabilities associated with the transferred equipment were equal to the partnership's adjusted basis in the property. Under the McEachrons' analysis, there was no gain on the transaction within the meaning of 26 U.S.C. § 1001(a) (1976). Thus, they contend there is no need to employ the rules applicable to gains on transfers of assets to corporations controlled by the transferor. See *id.* §§ 351, 357.

In response to this argument, the Tax Court held the record did not support the McEachrons' contention that the indebtedness associated with the equipment was equal to its adjusted basis at the time of the transfer. See *Owen*, 53 T.C.M. at 1485. The court held that Mr. McEachron and his partner were therefore required to recognize a gain on the transfer under 26 U.S.C. § 357(c). The court also held the gain should be offset by the amount of a certificate of deposit pledged by the partners as collateral for the indebtedness on the equipment.

See *Owen*, 53 T.C.M. at 1486. We have considered the McEachrons' arguments and agree with the Tax Court's analysis of the gain the McEachrons must recognize.

Accordingly, we affirm the Tax Court's decision.

## APPENDIX D

### (THREE APPROACH COMPARISON)

APPROACH:	SHAREHOLDER:			CORPORATION:		
	GAIN:		§ 358 Stock Basis	GAIN:		§ 362 Asset Basis
	Now	Potential		Now	Potential	
I. Negative Basis	0	100 <sup>1</sup>	(100)	0	100	100
II. Section 357(c)	100	0	0	0	0	200
III. Lessinger Case	0	100	0 <sup>2</sup>	0	0 <sup>3</sup>	200 <sup>4</sup>

**ASSUMPTIONS:** The taxpayer forms a new corporation and contributes as its sole asset equipment with an adjusted basis of \$100, a fair market value of \$100 and subject to a recourse liability of \$200. Since the corporation would not accept assets with a negative net worth of \$100 and because the shareholder wishes to avoid a "gain" under § 357(c), the shareholder either

<sup>1</sup>The negative basis is the only approach which generates two gains. The first gain accrues to the shareholder on the disposition of the stock which carries a negative basis. The second gain accrues to the corporation on the disposition of the asset subject to a liability which exceeds the basis in the asset in a like amount. Section 357(c) eliminated this double gain and the *Lessinger* approach would not reinstate it.

<sup>2</sup>A shareholder negative basis is avoided even though a § 357(c) gain is not imposed by viewing the asset and liability transfer as a property acquisition event—the acquisition of the stock. Since the shareholder is either giving a note to the corporation or remaining primarily liable on the liabilities, the transaction may be viewed as the acquisition of property which increases the shareholder's debt. Under *Crane* and *Tufts*, a taxpayer is given basis in property (here the stock) for any connected acquisition debt.

<sup>3</sup>Since the corporation is deemed to have two assets, the equipment subject to the liability and the money to be contributed by the shareholder under the note, the corporation can either use the money to pay down the liability so that liabilities no longer exceed basis or can realize a \$100 gain on the disposition of the equipment but suffer an offsetting \$100 loss when the creditor takes the \$100 to satisfy the recourse liability deficiency judgment of \$100. In either event, the corporation's net gain and loss is zero, the same as with the § 357(c) approach.

<sup>4</sup>The corporation actually has only a carryover basis of \$100 in the equipment but it will acquire an additional \$100 in basis in the cash when the shareholder contributes the money under the note (*Lessinger*) or when he constructively does so by paying the liability directly (*Owen*).

gives the corporation his note to pay the corporation \$100 in the future (*Lessinger*) or remains primarily liable to the recourse lender in an amount not less than \$100 and the corporation does not assume the liabilities. In both cases, the recourse lender requires the corporation to recognize its continuing purchase money security interest. In both cases, the shareholder either pays the note or the liabilities in due course.

